Comments of the Western Power Trading Forum to the California Air Resources Board on Cost-Containment Mechanisms

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The Western Power Trading Forum[1] (WPTF) appreciates the opportunity to provide input to the California Air Resources Board (ARB) on its consideration of options to contain costs under a greenhouse gas (GHG) cap and trade system. WPTF supports open and competitive markets generally and considers that a trading system is the most cost-effective means of reducing GHG emissions in the long-term. None-the-less, we recognize that no matter how well-designed the cap and trade system, unanticipated factors could lead to negative consequences, such as electrical system reliability problems. WPTF's preferred means of containing costs is to make the scope of the trading system as broad as possible, to provide capped entities with the flexibility to plan for the use of allowances over time, and to allow unlimited use of emission offsets. WPTF's responses to the specific issues raised in the white paper and at the April 25th workshop are provided below.

Temporal flexibility

WPTF believes that temporal flexibility for capped entities is an important means of containing costs of the GHG trading system. For this reason, WPTF advocates multi-year compliance periods of 3 – 5 years. In addition, WPTF supports unrestricted banking of allowances for use in subsequent compliance periods. Banking enhances market liquidity, incentivizes over-compliance in the early years of the program, and provides important flexibility to covered entities for long-term planning. This latter point is particularly important in light of the projected costs of achieving long-term emission reductions. WPTF does not support borrowing from future compliance periods.

Offsets and linkage to other GHG trading systems

Numerous studies have demonstrated that allowing offset credits has the potential to significantly reduce the costs of achieving GHG reduction targets. [2] For this reason, WPTF supports unrestricted use of offsets within California's cap and trade system. However, in the event that quantitative or geographic restrictions are imposed, there should be a clear roadmap established for expanding the use of offsets over time in order to provide market and regulatory certainty. For instance, if offsets for a California cap-and-trade program are limited to offsets geographically located within the states that are members of the Western Climate Initiative (WCI), it should be made clear that the use of offsets is intended to expand consistent with the implementation of additional regional programs, a federal program, and international programs.

Thus, while WPTF can potentially accept some quantity or geographic restrictions on the use of offsets during a transition period, WPTF urges the ARB to avoid implementation of an approach under which both the quantitative and geographic limits on the use of offsets are relaxed when

[1] WPTF is a diverse organization comprising power marketers, generators, investment banks, public utilities and energy service providers, whose common interest is the development of competitive electricity markets in the West. WPTF has over 60 members participating in power markets within the WCI member states and provinces, as well as other markets across the United States.

[2]For example, EPA Analysis of the Lieberman-Warner Climate Security Act of 2008 concluded that unlimited use of domestic offsets would reduce the costs of achieving emissions targets under the bill by about 62%, relative to a scenario under which offsets are not allowed.

certain price thresholds are reached. Linking the use of offsets to the price of allowances makes it exceedingly difficult for capped entities to plan for the use of offsets in their compliance portfolio, and discourages investments in GHG reduction projects.

WPTF also supports linkage of the California system to other compatible systems, such as RGGI and the WCI. However, we note that full linkage with the European and UNFCCC systems is not possible at this time, due to the fact that California emission allowances would not be recognized and accepted by those programs. Thus, any currently available linkages to the EU ETS and the CDM would instead function in an offset capacity, which should also be encouraged.

As WPTF has previously stated, development of a national GHG reduction program is a preferred approach to both link the US states in the reduction efforts and to engage in the international arena.

Cost-containment

WPTF's believes that regulators' most effective tools for containment of costs within the GHG trading system are the scope and design of the system. Broad sectoral coverage, multi-year compliance periods, unlimited banking and unlimited use of real, verified offsets will increase market liquidity, expand opportunities for low-cost GHG reductions, and substantially reduce the risk of unacceptably high costs. None-the-less, we recognize that consideration of other cost-containment mechanisms may be warranted.

In the April 25th presentation, ARB staff noted that AB32 contains an implicit safety-valve that authorizes the Governor to adjust the timing and level of GHG reductions in the event of "extraordinary circumstances, catastrophic events or the threat of significant economic harm".
In this regard, AB32 clearly, and in our view, appropriately, sets the terms under which a safety-valve could be triggered. However, WPTF urges the adoption of of cost-containment mechanisms that are limited to true damage control [in particular to ensure that electric system grid reliability is not impaired] and should not be triggered to address price volatility. The success of the cap and trade system will be dependent on providing a carbon price signal that is high enough to incentivize changes in generator dispatch, consumption, and long-term investments in low-GHG technologies and demand response and efficiency measures. ARB should ensure that any approach to cost-containment maintains this important price signal so that the overall environmental integrity of the cap and trade system is intact. For instance, if a cost containment measure calls for loosening of the cap in one year through, for instance through issuance of additional allowances, the overall integrity of the cap should eventually be restored by a reduction in the cap in future years. Under no circumstances, should there be a cost containment approach that is tied to a prescriptive and inflexible price trigger.

WPTF supports the establishment of a market oversight body with limited advisory authority to monitor market conditions, and to advise the Governor if intervention in the market is needed. Establishment of such a body would provide flexibility in identifying and responding to unforeseen circumstances without the need to rely on an inflexible, prescriptive price trigger.

Price floor

Some participants in this proceeding have called for establishment of a minimum price for allowances, which would direct the state to purchase allowances if the market price drops below a pre-specified threshold. Price floors are typically justified on the grounds that they can avoid a collapse in allowance prices such as occurred in Phase I of the European Union Emissions Trading Scheme (EU ETS), and thus protect the value of GHG reduction projects. It is for this reason that the Regional Greenhouse Gas Initiative (RGGI) has adopted a price floor in the form of an auction reserve price.

WPTF disagrees that a price floor is advisable, as it ignores the central role of the level of the emission cap in determining the price of allowances. To take the EU ETS example, it is widely accepted that the EU ETS was over-allocated in Phase I of the program. The collapse in allowance prices that occurred in late 2006 and 2007 was due to the fact that the emission cap was set too high – not to the absence of a price floor. Allowances prices for Phase 2, which has a much tighter cap, have remained in the 20-30 Euro per metric ton range.[3] RGGI allowances prices are expected to be quite low, and are currently trading in the range of $6 - $8 ton.[4] In contrast, emission reductions required under AB32 are much deeper than those in both Phase I of the EU ETS and RGGI. Allowance prices are therefore likely to be much higher than those under RGGI and in the EU ETS Phase 1.

While WPTF recognizes the importance of establishing clear price signals for long-term investments in GHG reductions, WPTF believes that these prices signals must be a function of how the cap itself has been sent, and not through direct interference in the market that will occur with a floor price.

Market Liquidity

WPTF wishes to comment on an issue that was not directly addressed in the white paper nor the workshop – market liquidity. WPTF believes that a liquid allowance market is essential to provide capped entities with compliance opportunities and moderate allowance prices. While market liquidity is not a design feature in and of itself, the design of a cap and trade system can greatly influence the liquidity of the allowance market. In particular, features that reduce the transaction costs of trading – such as trading platforms, participation of market intermediaries, and simple and straightforward trading rules – will also tend to increase the liquidity of the market and ensure that entities can acquire the allowances they need for compliance. We therefore encourage ARB to address these issues in its program design.

[3] European Climate Exchange, http://www.europeanclimateexchange.com/default_flash.asp

[4] RGGI credits are currently trading for $7- $8 per ton on NYMEX.
http://www.reuters.com/article/companyNews/idUSN0734473020080507